

**Examination of Certain Policies, Procedures, Controls, and
Financial Activity of the City of Irvine**



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The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.

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MIKE HARMON
AUDITOR OF PUBLIC ACCOUNTS

December 8, 2016

W. J. Noland, Mayor
Tobo Bryant, City Council Member/Mayor Pro Tem
City of Irvine
101 Chestnut ST
Irvine, KY 40336

Dear Mayor Noland and Councilman Bryant:

The Auditor of Public Accounts (APA) has completed its examination of certain financial management and other operational activities of the City of Irvine (City). This report summarizes the procedures performed and communicates the results of those procedures.

As part of this examination, the APA reviewed information related to the City, such as policies, procedures, and council meeting minutes; analyzed financial information, such as accounting ledgers, bank statements, invoices, financial statement audits, and payroll tax documentation; interviewed relevant parties, including the Mayor, City Clerk, and City Council members; and performed other procedures deemed necessary. Unless otherwise indicated, the examination period of this engagement was July 1, 2013 through March 31, 2016.

The purpose of this examination was not to provide an opinion on financial statements, but to review specific issues brought to our attention and provide recommendations to address deficiencies discovered during the examination. It should be noted that weaknesses identified during the examination period may have occurred in other periods not covered by this examination.

Detailed findings and recommendations based on our examination are presented in this report to assist all parties involved in implementing corrective action. Serious weaknesses were identified that impact the City's financial management and other operations. These weaknesses included:

- Noncompliance with state law regarding mayoral duties and payment of employee bonuses;
- Financial reporting weaknesses that led to the withholding of a large amount of state aid;
- Significant errors in payroll leading to IRS penalties, withholding of state aid, and withholding errors impacting City employees;



- A lack of proper segregation of duties and lack of proper supporting documentation for expenditures creating opportunities for fraud;
- Errors in vendor payments, record keeping and reconciliations leading to overdrawn bank accounts, failure to file required 1099 tax statements for vendors, and excessive bank fees and service charges; and
- Payments for expenditures that are not proper uses of public funds.

Due to the seriousness of these concerns, this report is being referred to the Office of the Attorney General, Internal Revenue Service, and the Kentucky Department of Revenue to determine whether further investigation is warranted.

We appreciate your assistance and the assistance of your staff and City Council throughout the examination. If you have any questions or wish to discuss this report further, please contact me or Libby Carlin, Executive Director of the Office of Technology and Special Audits at (502) 564-5841.

Thanks and God Bless,

A handwritten signature in black ink, appearing to read "Mike Harmon". The signature is fluid and cursive, with a long horizontal stroke at the end.

Mike Harmon
Auditor of Public Accounts



Examination of Certain Policies, Procedures, Controls, and Financial Activity of the City of Irvine

Impetus, Scope and Methodology

The Auditor of Public Accounts (APA), in response to concerns expressed to this office regarding certain financial management and other operational activities of the City of Irvine (City), initiated an examination to evaluate those concerns. The purpose of this examination was not to provide an opinion on the City's financial statements, but to review specific matters brought to our attention and make recommendations to strengthen and improve internal controls to ensure the City's financial management activities are accurate and transparent.

As part of this examination, the APA reviewed information related to the City, such as policies, procedures, and council meeting minutes; analyzed financial information, such as accounting ledgers, bank statements, invoices, financial statement audits, and payroll tax documentation; interviewed relevant parties, including the Mayor, City Clerk, City Council members, and the Operational Manager for Irvine Municipal Utilities; and performed other procedures deemed necessary. Unless otherwise indicated, the examination period of this engagement was July 1, 2013 through March 31, 2016.

City of Irvine

Located in Eastern Kentucky with a population of approximately 2,715, the City serves as the county seat for Estill County. The City follows the mayor-council form of government, which is the most common governance structure used by cities in Kentucky. The distinguishing characteristic of this form of governance is a strict separation of powers between the executive branch (the mayor) and legislative body (the city council).

The current mayor was first elected to office in 2014 to serve a four-year term beginning on January 1, 2015. The City Council consists of six elected members, each serving a two-year term. All current City Council members have served at least three terms in office, and three members have served seven or more terms.

During fiscal year (FY) 2016, records indicate that the City employed 23 individuals, including the Mayor. City employees provide functions in areas such as administration, police, fire, street and sanitation, and maintenance.

The approved annual budget for FY 2016 reflects expected revenues of \$1,430,204 and expected expenditures of \$1,252,426. According to the FY 2015 financial statement audit, the City's total revenues were \$1,282,290 with expenditures of \$1,211,178, and a total fund balance of \$348,988.

Findings and Recommendations

Finding 1: The City's Operating Environment Is Not Conducive To Proper Management Of City Functions

Numerous weaknesses were noted within the City's operations. These findings primarily relate to three underlying issues: (1) a difficult operating environment within the City due to disagreements and friction among the City's management, (2) poor financial management caused by a lack of adequate resources to carry out financial management functions and numerous financial errors that have been undetected or uncorrected, and (3) a lack of clear policies and procedures for general operations and financial management functions. The combination of these weaknesses created an environment in the City that is not conducive to proper management, creates significant opportunities for waste, fraud, or abuse that could

Executive Summary (Continued)

go undetected, and led to errors resulting in penalties, fees, and withheld state funds.

Recommendations: In addition to the recommendations noted throughout this report related to the detailed concerns summarized above, the City should:

- Improve the operational climate of the City to ensure all functions are appropriately carried out and properly monitored.
- Evaluate all significant operational processes to develop written financial policies and procedures, and codify these policies in a formal administrative code.
- Request guidance from the Kentucky League of Cities in developing an administrative code to ensure the City operates in an efficient, effective, and professional manner to benefit the public it serves.
- Formally approve the administrative code through an action of the City Council and distribute the code to all City employees.
- Review and update the administrative code on a routine basis.
- Comply with KRS 83A.060(11) by ensuring that the Code of Ordinances is examined. Revisions should be made to eliminate redundant, obsolete, inconsistent, and invalid provisions.

Finding 2: The City Has Not Followed State Law In The Division Of Certain Responsibilities Between The Mayor And City Council

Interviews with City Council members and the Mayor identified disagreements about who has the authority to execute certain duties. The disputed duties include removal of the City Clerk and Assistant City Clerk, budget preparation, hiring of the City Attorney, and the selection of a CPA firm to perform the City's annual financial statement audit. KRS 83A.130 defines the roles and responsibilities within a mayor-council form of government, and KRS 91A.030 stipulates a city's budget process and deadlines. An analysis of these statutes reveals all of the disputed duties are the responsibility of the Mayor, but the City Council

has not recognized the Mayor's statutory authority over these executive functions.

Recommendations: The City Council and Mayor should comply with the powers and duties of the executive and legislative bodies of a mayor-council form of government as set forth in Kentucky statutes. Section 31.30 of the Code of Ordinances should either be amended to reflect the actual requirements of KRS 83A.080(3) or abolished. The City Council should also examine the entire Code of Ordinances for consistency with state law and for conflicts with other ordinances. The City Council should then take action to revise those ordinances to eliminate redundant, obsolete, inconsistent, or invalid provisions. The City should develop and adopt policies that include clarification regarding the City's contracting process. When addressing policies and procedures within the City, the Mayor should also ensure his role has the appropriate oversight and effective decision making authority.

Finding 3: The City Routinely Failed To Meet Statutory Financial Reporting Requirements, Resulting in Noncompliances and State Funding Being Withheld

The City routinely failed to meet statutory requirements related to financial reporting. Budget-to-actual analysis for all funds and other information needed to properly monitor the City's budget was not provided to the City Council, and financial statement audits were not completed timely. In addition, when financial information was presented at City Council meetings, it was minimal, inconsistent, and insufficient to assist the City Council members in understanding the City's financial position accurately. As a result of the late and ineffective financial reporting, the City's expenditures exceeded approved budgets, annual financial audits were not completed for several years, and required financial reports were not submitted to the state causing a significant amount of state funds to be withheld until the City complied with these requirements.

Recommendations: The City should:

- Comply with all requirements of KRS 91A.030 regarding annual budgets and the

Executive Summary (Continued)

presentation of operating reports to the City Council, including budgetary comparison reports.

- Ensure that monitoring provisions enacted by the City Council related to City expenses are followed.
- Ensure required audit deadlines are met by engaging a firm to start the audit well in advance. The Mayor should oversee the process for contracting with the CPA firm and should request the firm to present the audit to the City Council upon completion.
- Take immediate action to address and correct weaknesses identified in the completed financial statement audits.
- Publish the required audit information to comply with KRS 91A.040(6) and KRS Chapter 424.
- Comply with Department for Local Government requirements and implement procedures to ensure the City's annual financial statement audits and Uniform Financial Information Reports are submitted timely.

Finding 4: Errors In Payroll And Contract Labor Tracking Led To IRS Penalties, State Revenue Intercepts And A Failure to Issue 1099s To Contractors

A review of the City's personnel files found missing and incomplete documentation. Testing also identified payroll withholding amounts were calculated incorrectly and that errors were submitted on federal wage and tax reports. These errors were identified by state and federal taxing agencies, and as a result the City incurred penalties and interest and had state payments intercepted due to the failure to properly submit employee withholdings. Additionally, the City's accounting system has a weakness that made it difficult to differentiate contract labor payments from other City expenditures. Therefore, this weakness created a significant risk of contract labor payments not being properly reported to individuals for tax purposes.

Recommendations: While payroll functions are now outsourced, the City should recognize it is ultimately still responsible for the accuracy of payroll processing, withholdings, and reporting. In addition, since outsourcing the payroll function removed significant duties from the City Clerk, the City should determine whether additional functions can be added to the City Clerk's role to justify the continuation of a full-time employee in the position. The City should ensure that up-to-date personnel files are maintained for every employee and elected official. The City should review its process for tracking contractor payments to ensure all expenses required to be reported to individual contractors, the Internal Revenue Service, and the Kentucky Department of Revenue have been identified. Since this function has not been outsourced, the City should ensure that the accounting system accurately identifies these contractor payments and enables the preparation of required tax documents.

Finding 5: The City's Accounting Functions Are Not Segregated, Increasing Opportunities For Waste, Fraud, And Abuse To Occur And Not Be Detected

The City Clerk is currently the only employee assigned to handle all accounting duties of the City, including accounts payable, accounts receivable, contracting, and procurement. As such, she has the ability to initiate transactions, record transactions, receive and process payments, deposit receipts, and reconcile the related accounting records.

Recommendations: The City's administrative code should address how financial activities will be segregated and what compensating controls will be implemented when necessary. Also, the City's dual signature practice on its accounts should be strengthened to ensure the check preparer cannot be the sole signer of checks. In addition, certain functions should not be under a single individual, such as the ability to open or close bank accounts without the approval of another individual. The authority vested in the City Clerk to act on behalf of the City should be clearly defined and known to all parties. The Mayor, City Council, and City Clerk should work to develop a contingency plan for dealing with both temporary and permanent absences by the City Clerk.

Finding 6: The City Had Weak Internal Controls Over Disbursements From The City's Bank Accounts

Serious weaknesses were identified related to expenditures from all of the bank accounts tested, including payments made from the City's payroll account. The results identified 253 of 302 transactions, or 84% of those tested, had inadequate or missing supporting documentation such as invoices or receipts, had no evidence of proper authorization indicating that anyone other than the City Clerk reviewed the invoice, were not for valid operational purposes of the City, or a combination of these issues.

Recommendations: The City should:

- Develop documentation requirements, along with a review and approval process, to ensure that all expenditures are supported, necessary, and properly authorized. All expenditures should be supported by a detailed receipt or invoice, and an explanation as to the operational purpose of the expenditure, if unclear.
- Maintain financial and other related documentation in a logical manner that permits documents to be easily located for reference, monitoring, and audit purposes. Implement the use of a voided check register, so that any voided checks can be accounted for and easily located.
- Implement procedures to ensure all payroll disbursements, including payments to employees, withholding entities, and others, are properly supported and accurately calculated.
- Develop documentation and approval requirements for petty cash. Documentation should not only include the total amounts withdrawn and deposited, but a running account of each transaction included in that total.
- Close all unnecessary bank accounts to improve the oversight and monitoring of the accounts.

Finding 7: The City Used Public Funds For Inappropriate Expenditures

Auditors identified excessive and questionable uses of City funds during the expenditure testing discussed in Finding 6. Auditors identified approximately \$4,441 in excessive and questionable expenditures during the examination. In the sample of expenditures tested, auditors noted purchases for gift cards and gift certificates. Additionally, concerns were noted during the examination related to expense reimbursements paid to employees and officials. During the examination, auditors identified two checks issued in July 2015 totaling \$504 made payable to the City Clerk. The memo line on these checks indicated they were for meal allowances for periods as far back as 2008, but were not supported by receipts or other documentation to justify the reimbursement. Section 3 of the Kentucky Constitution prohibits the payment of bonuses to public employees for the performance of their duties. In spite of this prohibition, auditors identified an invoice identifying \$975 in gift cards were purchased for employees with public funds.

Recommendations: As noted previously, the City should implement policies and procedures, including clear policies that address the type of expenditures that are allowable uses of public funds. The City should refrain from using public funds for employee bonuses in any form, purchasing flowers or gifts for bereavement and other occasions, meals for employees while not on travel status, and meals for family members of employees. The City should also revise its reimbursement policy for clarification of permitted reimbursements, and ensure all employees receive a copy of the policy. The City should adhere to all policies enacted and should refrain from paying reimbursements that do not meet the City's requirements for proper supporting documentation and timeframe. Reimbursements for purchases made on behalf of the City should be very limited due to the unintended wage and tax consequences this practice can create, and thorough documentation should be maintained for any such reimbursements that cannot be avoided. Finally, the City should establish strong review and approval procedures to detect noncompliant expenditures and to avoid unnecessary, excessive, and unauthorized expenses.

Introduction and Background

Impetus, Scope and Methodology

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The purpose of this examination was not to provide an opinion on the City's financial statements, but to review specific matters brought to our attention and make recommendations to strengthen and improve internal controls to ensure the City's financial management activities are accurate and transparent.

As part of this examination, the APA reviewed information related to the City, such as policies, procedures, and council meeting minutes; analyzed financial information, such as accounting ledgers, bank statements, invoices, financial statement audits, and payroll tax documentation; interviewed relevant parties, including the Mayor, City Clerk, City Council members, and the Operational Manager for Irvine Municipal Utilities (IMU); and performed other procedures deemed necessary. Unless otherwise indicated, the examination period of this engagement was July 1, 2013 through March 31, 2016.

City of Irvine

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Personnel

During Fiscal Year (FY) 2016, records indicate the City employed 23 individuals, including the Mayor. City employees provide functions in areas such as administration, police, fire, street and sanitation, and maintenance.

Financial Information

The approved annual budget for FY 2016 reflects expected revenues of \$1,430,204 and expected expenditures of \$1,252,426. According to the FY 2015 financial statement audit, the City's total revenues were \$1,282,290 with expenditures of \$1,211,178, and a total fund balance of \$348,988.

According to the FY 2015 financial statement audit, the City's primary governmental activities included general government, police, fire, and street and sanitation. These governmental activities were funded by the City's general tax and licensing revenue, as well as interest and other revenue.

Introduction and Background

The City also had one business-type activity funded by related user charges, IMU. IMU provides water and sewer treatment services to City residents and also sells water to residents living in the former Estill County Water District #1 service area. According to the City's most recent financial statement audit, IMU generated revenues of \$2,043,769 in FY 2015.

Findings and Recommendations

Finding 1: The City's Operating Environment Is Not Conducive To Proper Management Of City Functions

During the examination, numerous weaknesses were noted within the City's operations. These findings, presented in more detail throughout this report, primarily relate to three underlying issues: (1) a difficult operating environment within the City due to disagreements and friction among the City's management, (2) poor financial management caused by a lack of adequate resources to carry out financial management functions and numerous financial errors that have been undetected or uncorrected, and (3) a lack of clear policies and procedures for general operations and financial management functions. The combination of these weaknesses created an environment in the City that is not conducive to proper management, creates significant opportunities for waste, fraud, or abuse that could go undetected, and led to errors resulting in penalties, fees, and withheld state funds. These underlying concerns are discussed in more detail below.

Operating Environment

From the first days of the examination, auditors observed and heard about friction within the City's management, primarily between the Mayor and City Clerk. Although it is not uncommon to have workplace disagreements and relationship problems, it becomes an operational weakness when the environment creates difficulties in properly carrying out the day-to-day operations of the City. The effects of this environment include:

- An ineffective supervisor/employee relationship. At times during the examination, weaknesses were noted in which the Mayor's executive authority was bypassed by the City Clerk and City Council.
- Weaknesses in financial reporting. The examination identified a significant lack of segregation of duties and a lack of supervisory reviews or approval of important activities.
- Noncompliance with state laws and local ordinances. As the executive of the City, the Mayor is required to present budgetary reports to the City Council. The Mayor may delegate these duties to the City Clerk as he chooses, but the poor environment has created a gap in reporting that went largely uncorrected.

More specific examples of these issues and their effects are noted throughout this report. These issues create an environment that is not conducive to proper City operations. This environment increases the risk of errors, fraud, and noncompliance because it limits proper supervision and circumvents the executive authority put in place by state statute.

Poor Financial Management

The City does not have adequate staffing for proper financial management to ensure that financial accounting and reporting is timely, accurate, and properly segregated. Only one employee, the City Clerk, is tasked with handling the majority of the City's financial operations. During the timeframe covered by this examination, the City Clerk was responsible for handling all payroll, procurement and accounts payables, cash collections, general accounting, and reconciling.

Findings and Recommendations

Although not unusual in small governments, this structure puts a great deal of responsibility on one individual thereby creating a serious lack of proper segregation of duties. This condition increases the risk that waste, fraud, or abuse could occur and go undetected.

Additionally, during the examination, numerous errors and weaknesses were identified that raised questions as to whether the problems were a result of inadequate training and skills or even neglect of duty. These problems were largely undetected by the Mayor, former Mayor, or others, or were not corrected even when detected through correspondence with and penalties imposed by other agencies. These concerns were significant, and overall they identify a weak control structure that heightens the opportunity for fraud to occur, especially given the serious lack of segregation of duties. Some of the weaknesses discussed in greater detail in this examination, as well as other red flags that contribute to this concern, include:

- Failure to provide accurate financial reporting to the Mayor and City Council and overspending the City's approved budget;
- Lack of timely financial statement audits and failure to submit required Uniform Financial Information Reports;
- Payroll withholding errors resulting in IRS penalties and withholding of state funds due to the City;
- Failure to file required 1099s to independent contractors, including the City Attorney;
- Approval of an employee raise without the Mayor's signature;
- Bank reconciliations that were intermittent, inaccurate, and incomplete;
- Opening and closing bank accounts without the Mayor's knowledge or approval;
- Excessive amount of expenditures without supporting documentation, including over \$5,000 in petty cash withdrawals;
- Payment errors and improper controls over blank and voided checks; and
- Excessive and questionable expenditures and reimbursements, including the City Clerk reimbursing herself for three years of meal allowances without any supporting documentation.

The magnitude and frequency of these errors, as well as the lack of detection or correction by the City's management, left the City vulnerable to taxpayer dollars being lost to waste, fraud or abuse. Additionally, even without the identification of fraud, the City was impacted by delayed state payments and thousands of dollars lost in unnecessary penalties and fines.

Findings and Recommendations

Policies and Procedures

The City has not adopted an administrative policy manual or other written policies and procedures related to administrative and financial activities such as general accounting controls, reimbursements, payroll, banking, allowable expenditures, petty cash, procurement, fixed assets, and fuel usage. The development and adoption of policies and procedures are necessary for the City to maintain the internal controls needed to prevent and detect errors, waste, and potential fraud, and to ensure that City ordinances related to financial reporting and other matters impacting operations are properly administered. In the absence of documented policies and procedures, the City's activities are inconsistent, internal controls are weak and ineffective, and the City's risk of noncompliance with City and state laws is increased.

Currently, the City Clerk handles most financial activities for the City without the guidance of documented policies and procedures. Based on interviews conducted, the City Clerk performs these functions without any supervisory review and is the only person with a knowledge and understanding of the accounting system and City financial functions. The City Clerk is also the only party with complete knowledge of the numerous bank accounts used by the City.

Established and documented policies and procedures create a structure of rules that should be followed on a day-to-day basis. These policies can also address procedures to be used in times of transition or emergencies. Policies and procedures should be written and easily accessible to ensure that all employees are aware of the applicable rules and requirements. Without written policies and procedures, there is no clarity regarding the controls and safeguards that should be in place to ensure financial transactions are properly handled, recorded, and supported by documentation.

Lack of Review of Ordinances

In addition to the lack of written administrative policies and procedures, examination procedures also identified that the City's Code of Ordinances is not periodically reviewed as required by state law and also by the City's Code of Ordinances. Several City Council members interviewed agreed the City's Code of Ordinances had not been reviewed to ensure consistency with state law, for any conflicts between ordinances, or to eliminate redundant, obsolete, inconsistent, and invalid provisions. Both KRS 83A.060(11) and Section 32.40 of the City's Code of Ordinances require the City to examine its ordinances at least once every five years for these purposes. A specific example of such a conflict between state law and City ordinances involves the removal of nonelected officials, which is discussed in greater detail in Finding 2. This conflict may have been detected had the ordinances been reviewed periodically, as required.

These ordinances are official actions of the City Council that are enforceable as local law. The failure to periodically review active ordinances creates a risk of having conflicting laws in the City's record or having inconsistent application of the law.

Findings and Recommendations

Recommendations In addition to the recommendations noted throughout this report related to the detailed concerns summarized above, the City should:

- Improve the operational climate of the City to ensure all functions are appropriately carried out and properly monitored.
 - Evaluate all significant operational processes to develop written financial policies and procedures, and codify these policies in a formal administrative code.
 - Request guidance from the Kentucky League of Cities in developing an administrative code to ensure the City operates in an efficient, effective, and professional manner to benefit the public it serves.
 - Formally approve the administrative code through an action of the City Council and distribute the code to all City employees.
 - Review and update the administrative code on a routine basis.
 - Comply with KRS 83A.060(11) by ensuring that the Code of Ordinances is examined. Revisions should be made to eliminate redundant, obsolete, inconsistent, and invalid provisions.
-

Finding 2: The City Has Not Followed State Law In The Division Of Certain Responsibilities Between The Mayor And City Council

Interviews with City Council members and the Mayor identified disagreements about who has the authority to execute certain duties. The disputed duties include removal of the City Clerk and Assistant City Clerk, budget preparation, hiring of the City Attorney, and the selection of a CPA firm to perform the City's annual financial statement audit. KRS 83A.130 defines the roles and responsibilities within a mayor-council form of government, and KRS 91A.030 stipulates a city's budget process and deadlines. An analysis of these statutes reveals all of the disputed duties are the responsibility of the Mayor, but the City Council has not recognized the Mayor's statutory authority over these executive functions.

The distinguishing characteristic of the mayor-council governance structure is a strict separation of powers between the executive and legislative body. Pursuant to KRS 83A.130(3), the executive authority of the city is vested in the mayor, who is required to enforce city ordinances, orders, and applicable statutes. The mayor is also directed to supervise all departments of city government, including all city officers and employees under his jurisdiction. Any delegation of the mayor's duties or authority must be made by executive order, which would then be subject to modification by future mayors. KRS 83A.130(9) states, in relevant part, "[t]he mayor shall be the appointing authority with power to appoint and remove all city employees" More specifically, KRS 83A.080 clearly provides that the mayor has the authority to appoint and remove all nonelected city officials.

Findings and Recommendations

In the mayor-council form of government, the City Council is the legislative body that functions much like a board of directors, by setting policy and ratifying major decisions made by the mayor. The City Council is generally removed from the day-to-day operations of the City. KRS 83A.130(11) states, “The council shall not perform any executive functions except those functions assigned to it by statute.” The City Council, however, does have statutory approval authority in some instances, such as the appointment of nonelected city officials as described in KRS 83A.080.

KRS 91A.030 establishes the budget process for cities and provides that the preparation of the budget proposal is the responsibility of the mayor in cities operating under the mayor-council form of government. However, local ordinance governs the form and detail of the budget proposal. Ultimately, the city council is responsible for passing a budget ordinance to carry out the operations of city government. The administration and implementation of the adopted budget ordinance is then the responsibility of the mayor.

Removal of Nonelected City Officials

One of the key disputes between City officials relates to who has authority to dismiss certain nonelected employees. During the examination, auditors learned of the dismissal of an Assistant City Clerk in September 2015 that was carried out by the City Council, without the support of the Mayor. Additionally, interviews with the Mayor indicated he has been told that he lacks the authority to hire or dismiss either the City Clerk or Assistant City Clerk based on an ordinance enacted prior to his term. Inquiry into this matter identified that the current City Council is operating according to a local ordinance, in place since 1996, which purports to give the City Council, not the Mayor, the authority to remove the City Clerk and Assistant City Clerk. Section 31.30 of the City’s Code of Ordinances establishes the City Clerk and the Assistant City Clerk as nonelected city officers. This ordinance requires that “all non-elected city officers shall be appointed by the Mayor with approval of City Council.” Related to removal of officers, the ordinance states:

All non-elected officers may be removed by the Council at will unless otherwise provided by state law or ordinance. Upon removal of a non-elected officer at will, the Council shall give the officer a written statement setting forth the reason or reasons for the removal. However, this requirement shall not be construed as limiting in any way the at-will dismissal power of the Council.
(KRS 83A.080(3))

The removal portion of the ordinance is in direct conflict with KRS 83A.080(3), which gives the Mayor the authority to remove nonelected officers. KRS 83A.080(3) states, in relevant part:

Findings and Recommendations

The officers may be removed by the executive authority at will unless otherwise provided by statute or ordinance. Upon removal of a nonelected officer at will, the executive authority shall give the officer a written statement setting forth the reason or reasons for the removal. However, this requirement shall not be construed as limiting in any way the at-will dismissal power of the executive authority.

The statutory language, “unless otherwise provided by statute or ordinance,” causes some confusion with regard to the extent to which a council may limit the mayor’s authority to remove nonelected officers. The *City Officials Legal Handbook, 2015 Edition* (“*Handbook*”) published by the Kentucky League of Cities offers an interpretation of the confusing language in this statute:

[T]he language’s intent is to allow the council to adopt an ordinance which limits the at-will nature of the dismissal authority. The language is not intended to authorize the council to usurp the power of the mayor to dismiss nonelected officers. In other words, the council may enact an ordinance specifying that a nonelected officer may only be dismissed “for good cause” and after certain procedures are followed (such as notice and the opportunity for a hearing).

As the *Handbook* further notes, the statutory language should be read in conjunction with the overall separation of powers created in the mayor-council governance form. The authority to terminate a nonelected officer is an executive function expressly given to the mayor, and such functions are not to be performed by the council pursuant to KRS 83A.130(11). Therefore, it appears that the City Council has overstepped its statutory authority in restricting the Mayor’s ability to remove nonelected city officials.

Budget Process and Responsibilities

Another disputed duty relates to the City’s annual budget process. Concerns were expressed that the current Mayor did not seek input from City Council members prior to delivering the budget proposal for consideration in a public City Council meeting. Interviews with City Council members indicated that the two previous mayors were more inclusive when it came to the budget preparation and administrative process, including having budget work sessions.

KRS 91A.030(5) states, “Preparation of the budget proposal shall be the responsibility of the executive authority of the city in cities operating pursuant to KRS Chapter 83, KRS 83A.130 or 83A.140” Although in practice, budget work sessions or other communications prior to the submission of a budget proposal may improve the budget process by identifying and resolving disagreements or questions in advance, state law does not require the mayor to seek advance input from council members.

Findings and Recommendations

After the budget proposal has been submitted, it is the City Council's responsibility, before July 1 of each year, to adopt an annual balanced budget for the upcoming fiscal year. KRS 91A.030(8)(a) states, in relevant part, "The legislative body shall adopt a budget ordinance making appropriations for the fiscal year in such sums as the legislative body finds sufficient and proper, whether greater or less than the sums recommended in the budget proposal." KRS 91A.030(10) also permits the City Council to adopt budget amendments.

As noted above, after adoption of the budget ordinance, responsibility passes back to the mayor to administer and implement the budget pursuant to KRS 91A.030(11). No expenditures may be made that are not in accordance with the amounts appropriated in the budget ordinance, and the mayor is required to provide the council with operating statements that include budgetary comparisons of each governmental fund. This requirement has not been met until recently and is discussed in more detail in Finding 3.

Selecting City Attorney and CPA Firm

Another area of disagreement between the Mayor and City Council members is the authority to bind the City in the hiring or dismissing of professional service contractors, such as the City Attorney or the CPA firm that conducts the annual audit of the City's financial statements. This examination identified that at times, the City Council took action on the hiring and retention of contractors, without the agreement of the Mayor. KRS 83A.130(8) states, "All bonds, notes, contracts and written obligations of the city shall be made and executed by the mayor or his agent designated by executive order." Based on this statute, contractual decisions fall under the authority of the Mayor, and therefore, the City Council's actions to override the Mayor's authority in hiring or dismissing contractors have not complied with state law.

The City Attorney was appointed by a previous City Mayor, and the City Clerk was unable to locate a written contract for the City Attorney. When questioned about potential conflicts in the City Attorney's role because the same individual also acts as the County Attorney, the Mayor indicated he was not sure he had the authority to make a change in the City Attorney position, if warranted. Additionally, inquiries with City Council members indicated that the council would take action to retain the City Attorney if the Mayor relieved him of his duties. The Mayor has the authority to enter into professional services contracts on behalf of the City so long as the contracts are in accordance with budgeted amounts for such services. Further, professional service contractors, such as the City Attorney, should have current, written contracts in place to establish the obligations of both the contractor and the city, including contracted rates for hourly work or other terms of payment.

Findings and Recommendations

Although the current Mayor was involved in selecting a CPA firm for conducting the FY 2011 through FY 2014 financial statement audits, with approval of the City Council, it was actually the City Council who took action to let the contract for the FY 2015 audit. Based on information obtained during the examination, the City Council tasked the City Clerk with finding a new CPA firm. Although the City Clerk was involved at the request of the City Council, the poor operating environment discussed in Finding 1 resulted in the Mayor being effectively omitted from the process. The Mayor’s lack of authority or oversight of this process does not appear to comply with the intent of KRS 83A.130. This situation also adds additional credence to concerns related to the lack of an appropriate operating environment discussed in Finding 1.

Recommendations

The Mayor and City Council should comply with the powers and duties of the executive and legislative bodies of a mayor-council form of government as set forth in Kentucky statutes. Section 31.30 of the Code of Ordinances should either be amended to reflect the actual requirements of KRS 83A.080(3) or abolished. As noted in the recommendations for Finding 1, the City Council should also examine the entire Code of Ordinances for consistency with state law and for conflicts with other ordinances. The City Council should then take action to revise those ordinances to eliminate redundant, obsolete, inconsistent, or invalid provisions.

Also as part of the administrative code recommended in Finding 1, the City should develop and adopt policies that include clarification regarding the City’s contracting process. This policy should adhere to state procurement laws and could include requirements for notifying the City Council of a contract.

When addressing policies and procedures within the City, the Mayor should also ensure his role has the appropriate oversight and effective decision making authority. Although there are instances in which the Mayor may delegate duties, other employees or officials should not be empowered, explicitly or implicitly, to override his executive authority.

Finding 3: The City Routinely Failed To Meet Statutory Financial Reporting Requirements, Resulting In Noncompliances And State Funding Being Withheld

The City routinely failed to meet statutory requirements related to financial reporting. Budget-to-actual analysis for all funds and other information needed to properly monitor the City’s budget was not provided to the City Council, and financial statement audits were not completed timely. In addition, when financial information was presented at City Council meetings, it was minimal, inconsistent, and insufficient to assist the City Council members in understanding the City’s financial position accurately. As a result of the late and ineffective financial reporting, the City’s expenditures exceeded approved budgets, annual financial audits were not completed for several years, and required financial reports were not submitted to the state causing a significant amount of state funds to be withheld until the City complied with these requirements.

Findings and Recommendations

City Budget Reporting

KRS 91A.030(11) states, “Administration and implementation of an adopted budget ordinance shall be the responsibility of the executive authority of the city. That responsibility shall include the preparation and submission to the legislative body of operating statements which shall include budgetary comparisons of each governmental fund for which an annual budget has been adopted. These reports shall be submitted not less than once every three (3) months in each fiscal year.”

During the examination, evidence indicated that budgetary comparison reports to analyze budgeted amounts to actual receipts and disbursements were not provided to City Council members for monitoring purposes. This noncompliance was identified as a finding in the City’s financial statement audits for FY 2012, FY 2013, and FY 2014. Even so, budget comparison reports were not provided to the City Council until after being specifically requested by a City Council member at the January 11, 2016 council meeting. According to City Council meeting minutes, this report was not documented as being presented until March 14, 2016, when the City Clerk provided a report of budget to actual amounts for the previous quarter and for the fiscal year-to-date. Even then, the provided report was not in the format of the approved budget and included information only for the General Fund.

Because the responsibility for this reporting rests with the Mayor, auditors followed up to determine why the Mayor was unable to present this information to the City Council. The Mayor stated, “I am not an accountant, so I relied on the Clerk, and she did not provide me with anything.” This response was indicative of observations made by auditors and comments provided throughout the examination, resulting in an operational environment not conducive to proper management of the City (see Findings 1 and 2).

Another budget-related finding in the FY 2012, FY 2013, and FY 2014 financial statement audits was that the City’s actual expenditures exceeded the budgeted amounts. Overspending an approved budget ordinance without an amendment is a violation of KRS 91A.030(13), which restricts spending in excess of the amount appropriated. There was no documentation of any attempts to amend the budget ordinance during our examination period.

Prior to the City Council meeting on September 14, 2015, it does not appear either the Mayor or the City Clerk regularly presented financial information to City Council members. At the council meeting on August 24, 2015 in which the FY 2014 audit was presented, a City Council member made a motion to have all bills associated with the City presented on a bi-weekly basis. The motion passed, and this item was placed on the agenda for subsequent meetings.

Findings and Recommendations

However, based on interviews with City Council members and the Mayor, the City Clerk does not generally present this information at the council meetings, but rather provides a packet of information that includes a manually created table of vendors paid, as well as bank statements and reconciliation sheets. Therefore, in the absence of a formal budget-to-actual analysis, the presentation of any financial information appears to be inconsistent and insufficient to assist the Council members in understanding the City's financial situation.

Additional budget-related concerns were identified during this examination that reflect poor recordkeeping and potential instances of noncompliance with KRS 91A.030. Although not as significant as the matters above, these instances of noncompliance identify lax processes and inconsistent or erroneous documentation. These additional concerns include:

- Council meeting minutes do not reflect that the FY 2014 budget received a second reading.
- Although council meeting minutes did reflect that the FY 2015 budget received a second reading, the first reading is not documented in the minutes.
- It does not appear that the former or current Mayor presented the budget within 30 days prior to the end of the fiscal year as required during the three years reviewed.

*City Audits and
Uniform Financial
Information Reports*

KRS 91A.040(1) requires that “each city shall, after the close of each fiscal year, cause each fund of the city to be audited by the Auditor of Public Accounts or a certified public accountant. The audits shall be completed by February 1 immediately following the fiscal year being audited.”

This audit requirement has not been met by the City over the past several years. The City's FY 2010 audit is dated January 2015, and its annual financial statement audits for FY 2011 through 2014 were dated in July and August 2015. Additionally, its FY 2015 audit was presented in October 2016. Therefore, six of the most recently issued audits failed to meet the statutory deadline for completion. Auditors found that when the City did attempt to catch-up on its annual audits, several audits identified significant problems and resulted in disclaimed opinions as discussed in more detail below.

Findings and Recommendations

After catching up on financial statement audits through FY 2014, City Council members stated they did not want to use the same CPA firm that had completed the FY 2011 through FY 2014 audits to complete the FY 2015 audit. The contract for the audit of the City's FY 2015 financial statements was not approved until the February 22, 2016 Council meeting, which was 21 days after the audit was required to be completed by state law. One problem the City had with procuring a CPA firm to perform the annual financial statement audit was the disagreement over hiring a firm, as discussed in Finding 2. There has been confusion regarding the appropriate authority for hiring the firm to conduct the audits, with the City Council being heavily involved in the hiring of the last firm and the Mayor effectively excluded from the process in spite of his statutory authority over City contracts.

In addition to not being timely, the FY 2012 through FY 2014 audits resulted in disclaimed opinions for several of the City's opinion units - Governmental Activities, General Fund, Special Depreciation Fund, Municipal Road Aid Fund, and aggregate remaining fund information. In government audits, since governments are comprised of multiple reporting units, such as funds, departments, programs, etc., audit opinions are provided for each major type of reporting unit or a combination of reporting units that have certain financial commonalities. It should be noted that although still noncompliant due to being completed more than three and a half years after the fiscal years under audit, the audits for FY 2010 and FY 2011 resulted in unmodified, or "clean" audit opinions, as did the most recent audit for FY 2015. Also, although not presented in all audit reports over the past six fiscal years, the City has received clean audit opinions on its Business-type Activities and Enterprise Fund opinion units, which are related to the activities of IMU.

On the disclaimed opinion units, the audit reports reflected that opinions could not be given for these areas because, "The City of Irvine was unable to provide supporting documentation for a material amount of expenditures for the opinion units" The inability to give an audit opinion due to inadequate supporting documentation is a serious concern, and it should be immediately investigated and corrected by the City. The lack of documentation not only impairs the City's transparency, but also keeps the City's management, City Council, auditors, and its citizens from confirming that the City's funds were used for their intended purposes.

The City also failed to have its annual financial statement audits published as required by statute. KRS 91A.040(6) states, in part, "Each city shall, within thirty (30) days after the presentation of an audit to the city legislative body, publish an advertisement in accordance with KRS Chapter 424" The information required in the advertisement includes the auditor's opinion letter, budgetary comparison schedules for major funds, and information about where the complete audit report may be viewed by the public. The City Clerk published an advertisement for the FY 2014 audit after it had been presented to the City Council. However, the advertisement did not contain all required elements. A letter included in this advertisement was not the auditor's opinion letter, and it actually did not even relate to the FY 2014 audit. Also, this advertisement was not published until April 7, 2016, over seven months after the presentation of the FY 2014 audit at the August 24, 2015 council meeting.

Findings and Recommendations

Additionally, the City has not been timely in submitting its Uniform Financial Information Reports (UFIRs) to the Department for Local Government (DLG). Information obtained from DLG indicated that the City submitted its FY 2009 and FY 2010 UFIRs on time. However, UFIRs for FY 2011, FY 2012, and FY 2013 were not submitted on time, which resulted in state Municipal Road Aid payments being withheld from the City. When the City submitted its FY 2014 UFIR on February 2, 2015, it also submitted the late UFIRs for FY 2011, FY 2012, and FY 2013. Therefore, all withheld Municipal Road Aid funds that had accumulated through that date were released, totaling \$181,557. The FY 2015 UFIR, which was due to DLG by May 1, 2016, was not submitted until October 17, 2016. As a result, \$23,576 in Municipal Road Aid was withheld from the City for several months.

Recommendations The City should:

- Comply with all requirements of KRS 91A.030 regarding annual budgets and the presentation of operating reports to the City Council, including budgetary comparison reports.
- Ensure that monitoring provisions enacted by the City Council related to City expenses are followed. Relevant financial information should be presented to the City Council with opportunity given for discussion.
- Ensure that required audit deadlines are met by engaging a firm to start the audit well in advance. The Mayor should oversee the process for contracting with the CPA firm and should request the firm to present the audit to the City Council upon completion.
- Take immediate action to address and correct weaknesses identified in the completed financial statement audits, including those weaknesses related to a lack of supporting documentation that led to the inability to render an audit opinion in four of its five most recently completed audits.
- Publish the required audit information to comply with KRS 91A.040(6) and KRS Chapter 424.
- Comply with DLG requirements and implement procedures to ensure the City's annual financial statement audits and UFIRs are submitted timely.

Finding 4: Errors In Payroll And Contract Labor Tracking Led To IRS Penalties, State Revenue Intercepts, And A Failure To Issue 1099s

A review of the City's personnel files found missing and incomplete documentation. Testing also identified payroll withholding amounts were calculated incorrectly and that errors were submitted on federal wage and tax reports. These errors were identified by state and federal taxing agencies, and as a result the City incurred penalties and interest and had state payments intercepted due to the failure to properly submit employee withholdings. Additionally, the City's accounting system has a weakness that made it difficult to differentiate contract labor payments from other City expenditures. Therefore, this weakness created a significant risk of contract labor payments not being properly reported to individuals for tax purposes.

Findings and Recommendations

Payroll Errors

Testing of City personnel files found missing files and missing personnel documentation. Instances were found in which the City Clerk improperly calculated and submitted payroll information to various reporting authorities during the examination period. Auditors requested personnel files for 12 of the 41 individuals paid through the City's payroll process during the examination period. Three of the individuals were elected officials, and the remaining nine were City employees. The City Clerk, who processed the City's payroll during the examination period, was unable to locate the files for two individuals, one of whom was a current employee. The files for seven of the remaining ten employees tested lacked at least one of the three main documents necessary to determine the proper withholding amounts for employees, such as W-4, K-4, and I-9 forms, or the documents found in the files were incomplete. The financial statement audits for FY 2012, FY 2013, and FY 2014 also noted that numerous employees lacked a completed I-9 or other required supporting documents in their files.

During the examination, auditors observed documents in which the City reported different wage totals for the same period on two or more versions of the same form making it impossible to determine which version was used to determine payment. Also, auditors noted that withholding payments were not always paid for the amount due. The IRS also reported this discrepancy to the City in a letter dated June 15, 2011. This concern, coupled with the missing or incomplete documentation noted above, led to further testing to determine if other errors or inconsistencies existed related to employee payroll.

Auditors attempted to verify the accuracy of dollar amounts withheld from a sample of employee paychecks. Test results showed that the amounts calculated by the auditor and the amounts actually withheld from employee paychecks differed for each employee. Auditors tested the payroll withholding calculations of eight employees for calendar year 2014 and nine employees for calendar year 2015, with errors identified for all of the employees tested. This situation is concerning because employees are not generally aware of withholding errors during the course of a tax year, and therefore, the errors could lead to higher than anticipated amounts of taxes due when employees file their annual tax returns. Based on our testing, approximately \$10,400 in total withholding errors were found for calendar year 2014, and approximately \$8,900 in withholding errors were found for calendar year 2015.

These miscalculations could also have long-term negative effects on the individual's Social Security and Medicare contributions. The Federal Insurance Contributions Act (FICA) guidelines dictate that Social Security and Medicare tax rates should be calculated at the same percentage for every employee based on amount earned, but testing showed that these rates differed for the employees tested. When testing the FICA contributions for calendar year 2014, Medicare rates varied from 1.45 to 1.75 percent with the appropriate federal taxing rate being 1.45 percent. Social Security rates should have been 6.20 percent, but were actually applied at rates ranging from 6.20 to 7.47 percent. These federal rates stayed the same in calendar year 2015, but testing identified that the rates applied in 2015 for these employees varied from 1.45 to 1.79 percent for Medicare and ranged from 2.97 to 7.63 percent for Social Security.

Findings and Recommendations

Testing identified the City Clerk does not always submit tax payments timely or for the correct amounts. This conclusion was further supported by IRS and Kentucky Department of Revenue (DOR) correspondence to the City. CPAs hired by the City to perform the FY 2011 through FY 2014 audits notified the Mayor that the City incurred penalties and interest of \$9,844 to the IRS and \$8,085 to DOR between January 1, 2010 and September 30, 2015. In a letter dated June 19, 2014, the IRS refused to remove any penalties and interest applied to the City's account due to a longstanding history of failure to make timely payments. In addition, a letter from DOR dated May 22, 2008 shows that the state intercepted the City's Kentucky Law Enforcement Foundation Program Fund (KLEFPF) payments to recover withholding taxes due from the City. That money should go to provide a stipend payment to eligible law enforcement officers on the city police force. Auditors attempted to confirm with the City Clerk whether the police officers still obtained their KLEFPF incentive pay even though the funds had been intercepted. The City Clerk provided information about how the payroll was handled in general, but was unable to provide information to confirm the payments were in fact made.

Payroll errors were also identified in a prior financial statement audit. The City Clerk indicated that the problem was caused by the City's payroll software, and that the software withholding percentages were set up by a CPA firm hired by the City several years ago. During the examination, the City outsourced all functions of payroll to an outside vendor. The vendor began handling the process effective June 1, 2016. According to the City Clerk, the vendor confirmed that the City's accounting software "was taking too much out of some employees and not enough out for other employees check." Under the City's arrangement with the vendor, the City Clerk only forwards the vendor the breakdown of the individual's hours worked or leave time (regular, overtime, sick, or vacation). The vendor then handles the payroll process, including the tax calculations. It should be noted that although the City may outsource certain administrative functions, like payroll, the City is still ultimately responsible for ensuring accurate processing and reporting. The City's current process for monitoring the vendor's activities is unclear. Likewise, the City is ultimately responsible for ensuring that any software relied upon in processing payroll is working properly to enable the City calculate and correctly pay tax withholdings to the state and federal governments.

1099-MISC Reporting Errors

While conducting expenditure testing, auditors requested all 1099-MISC Forms issued during our examination period. Employers are required to issue a Form 1099-MISC to each person paid at least \$600 during the year for items such as rent, payments to an attorney, and services performed by someone who is not your employee. The City Clerk only provided 1099-MISC Forms for calendar year 2015. No evidence exists to indicate that, prior to calendar year 2015, the City Clerk distributed 1099-MISC Forms to any individual or company. The City Attorney is paid more than \$600 annually and should receive a 1099-MISC Form. However, the

Findings and Recommendations

evidence provided only supports that the City issued a 1099-MISC Form to the City Attorney for calendar year 2015. Although payroll functions have now been outsourced to a vendor, 1099 eligible contract payments are not processed through the payroll system, but instead through the City’s general accounting system. Therefore, the outsourcing of payroll does not address this weakness.

Recommendations

While payroll functions are now outsourced, the City should recognize it is ultimately still responsible for the accuracy of payroll processing, withholding, and reporting. The City should therefore monitor the vendor for any performance issues. In addition, since outsourcing the payroll function removed significant duties from the City Clerk, the City should determine whether additional functions can be added to the City Clerk’s role to justify the continuation of a full-time employee in the position.

The City should ensure that up-to-date personnel files are maintained for every employee and elected official. Additional training should be obtained to address deficiencies noted in maintaining adequate personnel records. Although the payroll function has been outsourced, changes in employee status, personnel actions, and other human resource documentation should be maintained by the City.

The City should review its process for tracking contractor payments to ensure all expenses required to be reported to individual contractors, the IRS, and DOR have been identified. Since this function has not been outsourced, the City should ensure that the accounting system accurately identifies these contractor payments and enables the preparation of required tax documents.

Finding 5: The City’s Accounting Functions Are Not Segregated, Increasing Opportunities For Waste, Fraud, And Abuse To Occur And Not Be Detected

The City Clerk is currently the only employee assigned to handle all accounting duties of the City, including accounts payable, accounts receivable, contracting, and procurement. As such, she has the ability to initiate transactions, record transactions, receive and process payments, deposit receipts, and reconcile the related accounting records. There is no supervisory review of these functions, and as a result, there is significantly inadequate segregation of duties. During part of the examination period, an Assistant City Clerk was employed to help divide these responsibilities and segregate at least some functions. However, the last individual in that position was terminated in September 2015, and the vacancy has not been filled.

A fundamental element of internal control is the separation of duties so that one individual cannot carry out and either inadvertently or deliberately conceal errors or fraud when performing accounting functions. Strong internal controls require the segregation of responsibilities for authorizing transactions, physical custody of assets, the related recordkeeping, and account reconciliation. A single person with multiple roles has the opportunity to abuse those powers. For example, to detect errors or fraud, the person who deposits cash should not reconcile the bank statements, the person who reconciles the bank statements should not book entries to the general ledger, and the person who sets up new employees in the accounting system should not process payroll. The City Clerk’s role includes all of these functions.

Findings and Recommendations

As previously discussed in Finding 1, the City also lacks written administrative policies and procedures over accounting functions. This means that the City has not formally addressed how the duties over its financial activities will be segregated or what compensating controls, if any, will be implemented to reduce vulnerabilities. When duties cannot be separated or staff size prohibits segregation of duties, compensating controls should be put in place. Compensating controls can act as a backup to help the City identify errors or fraud later in the process. In addition, this concern has been noted in the City's financial statement audits but has not been addressed. Therefore, it is possible that City officials are unsure how to properly separate these duties.

Due to the City's lack of segregation of duties, serious opportunities exist for errors, noncompliance, circumvention of authority, and fraud. The following are examples identified during the examination that illustrate the results of the City's failure to segregate financial activities or implement proper compensating controls:

- The City Clerk approved a raise for an employee without the Mayor's signature.
- Bank reconciliations performed by the City Clerk were intermittent, inaccurate, and incomplete. Because of the lack of segregated duties, including supervisory reviews, these errors were not detected. Additionally, these reconciliation errors prevented the City Clerk from having adequate information regarding the bank balances in a timely manner, leading to instances of overdrawn bank accounts.
- The City Clerk opened and closed bank accounts without another person reviewing whether this was necessary or appropriate. The City Clerk received funds from one bank account closure, and the check was left unattended in her desk drawer for several months. The City Clerk ultimately opened a new account at a different bank, but the opening balance for the new account was a higher amount than the ending balance for the old account with no documented reason to justify this discrepancy.
- The City Clerk maintained a bank account for which she did not recall the purpose of the account.
- One of the City's 11 bank accounts only required the City Clerk's signature, while the other 10 bank accounts required two authorizing signatures. The lack of written policies and procedures makes it unclear whether this practice was permissible.
- Because the City Clerk was the only individual with knowledge of the City's accounting system, passwords, and the status of all financial activities, the City's financial activity effectively shut down when she was out of the office. Also, the City has not developed a contingency plan involving the potential loss of the City Clerk (through retirement, dismissal, reassignment, long-term sickness, etc.) or considered the impact this loss might have on the City's financial activities.

Findings and Recommendations

Recommendations The City's administrative code should address how financial activities will be segregated and what compensating controls will be implemented when necessary. These procedures should include a review of work performed by the City Clerk to ensure that transactions are appropriate and that the risk of errors or fraud is reduced. An example of such a review could involve the Mayor or a member of the City Council reviewing monthly bank statement reconciliations for completeness and correctness. Also, the City's dual signature practice on its accounts should be strengthened to ensure the check preparer cannot be the sole signer of checks. In addition, certain functions should not be under a single individual, such as the ability to open or close bank accounts without the approval of another individual. The authority vested in the City Clerk to act on behalf of the City should be clearly defined and known to all parties. The Mayor, City Council, and City Clerk should work to develop a contingency plan for dealing with both temporary and permanent absences by the City Clerk.

Finding 6: The City Had Weak Internal Controls Over Disbursements From The City's Bank Accounts

Expenditure Processing

During the examination, auditors tested disbursements from the City's bank accounts to determine whether proper supporting documentation was available to support expenditures, whether appropriate authorization was documented, and whether the disbursements were for valid operational purposes of the City. Serious weaknesses were identified related to expenditures from all of the bank accounts tested, including payments made from the City's payroll account.

Auditors tested a total of 302 expenditures incurred by the City during our examination period. These expenditures were selected from the bank statements of eight of the City's 11 bank accounts. The results identified 253 transactions, or 84% of those tested, had inadequate or missing supporting documentation such as invoices or receipts, had no evidence of proper authorization indicating that anyone other than the City Clerk reviewed the invoice, were not for valid operational purposes of the City, or a combination of these issues. The City had no supporting documentation at all for 17 of the 253 transactions.

City expenditures should be supported by documentation that provides the details of the expense, the operational purpose of the expense, and evidence that the expense was approved by the Mayor. The lack of documented approval is a significant weakness, because unapproved expenditures have a higher risk of being unrelated to legitimate operational purposes. Further details on the identification of inappropriate expenditures are discussed in Finding 7.

Included in these deficiencies were \$5,090 in petty cash withdrawals without any supporting receipts. Petty cash expenditures should always be accompanied by receipts to support the reasons for the expenditure. The current lack of controls by the City led to a large number of unsupported petty cash withdrawals during the examination period. Since these withdrawals lacked supporting documentation, the authorization, purpose, and necessity of these cash withdrawals remain unknown. Because they are not closely monitored and consist of cash, these types of expenditures create a high risk of fraud or misappropriation.

Findings and Recommendations

The 253 instances of missing and insufficient supporting documentation demonstrate a serious deficiency in the City's recordkeeping. Records should be maintained in a manner that allows supporting documentation to be located quickly. Again, as noted in Finding 1, there are no policies or procedures that address the City's administrative functions, including documentation requirements. Therefore, proper controls are not in place to ensure that adequate accounting practices are in effect and that compliance is being monitored. Such an environment creates an increased opportunity for errors, as well as fraud.

Payment Errors, Blank and Inaccurately Voided Checks

In addition to the concerns noted above, auditors identified mistakes during expenditure processing, which included double payments, late payments, over payments, and a payment sent to the wrong address. Blank checks and checks that were improperly voided were found in various files during the examination. Auditors also confirmed the City Clerk did not maintain a voided check registry. The following are examples of issues that the auditors found in the files:

- Blank checks with no notes as to their purpose;
- A check made payable to a payee, but not signed or delivered, without explanation;
- A check made payable to a payee containing actual signatures, but neither delivered nor voided;
- A signed check voided with the word "Void" written on the check in pencil; and
- A check made out to Petty Cash voided with the word "Void" written in a pale yellow highlighter.

The condition of these checks, some of which appeared to be valid negotiable forms of payment, and the lack of a voided check registry to quickly ascertain which checks have been voided and why, leaves the City vulnerable for fraudulent activity to occur.

Bank Transfers and Service Charges

During the examination period, the City Clerk made 104 transfers between the various City bank accounts. Of these transfers, 78 related to moving money from other funds into the payroll account for payment, which would be a legitimate transfer purpose. However, auditors identified the transfers into the payroll account were not always made in the exact amount needed to cover the payroll liability for the period.

Many other transfers appear to be made to correct deposits that were erroneously made to the wrong bank accounts. These transfers present a risk in that they often lose the detail associated with the purpose of the original deposit and are difficult to follow through the accounting system to ensure the deposits were accurately corrected.

Findings and Recommendations

The City incurred \$3,311 in bank fees during the examination period. These fees included service charges, return item fees, overdraft fees, deposit correction fees, and analysis service charges for not maintaining a minimum account balance, which would have been avoidable with proper monitoring and review of financial activities. The majority of these fees related to the additional cost of paper bank statements from one of the banks the City utilizes, which is also an avoidable cost since the bank provides electronic statements free of charge.

*Disbursements from
the Payroll Bank
Account*

Auditors also reviewed the City's payroll bank account and attempted to test a sample of 112 disbursements, which included 31 payroll payments made to two employees over the examination period and 81 non-employee disbursements. The City Clerk was unable to present sufficient information regarding any of the disbursements selected for testing.

For the 31 payroll payments made to employees, auditors requested support to identify the calculations used to arrive at the net check amount, such as gross payroll and the amount of all withholdings. The City Clerk indicated she did not have anything that would show the auditors that information for the individual checks selected.

The majority of the additional 81 non-employee disbursements were payments to the IRS, DOR, and other withholding entities. When asked for the supporting detail for the withholding payments, the City Clerk provided the auditors with vendor files that contained prepared tax forms. However, the items in the file were not organized and did not have check stubs or check numbers identified, making it difficult for auditors to reconcile which supporting item related to which payment. Payroll withholding issues are discussed in more detail in Finding 4.

Also included in the non-employee disbursements were checks that appeared to be for questionable purposes. Auditors identified four checks made payable to individuals with a description stating "Refunds for Retirement," but none of the four individuals were employees during the period of the examination. The City Clerk indicated the refunds were due to over-withheld retirement amounts, but she did not have supporting documentation identifying the time period the retirement withholdings were in error, how the amount of the reimbursement was determined, or even that the individuals paid were former employees. Another concerning disbursement from the payroll account was a payment to a grocery store, which the City Clerk indicated was due to an employee who cashed a payroll check at the store, but the check written from the City's payroll account bounced. As a result, the City paid the grocery store directly to clear the bounced check, which included the face value of the check plus an additional \$55 in administrative fees charged by the grocery store to rerun the check.

All of the weaknesses identified in this finding indicate a serious lack of proper internal controls within the City's daily operations. A lack of supporting documentation makes it difficult to understand the need for the expenditure, but also significantly increases the risk that waste, fraud, or abuse could occur and go undetected.

Findings and Recommendations

Recommendations The City should:

- Develop documentation requirements, along with a review and approval process, to ensure that all expenditures are supported, necessary, and properly authorized. All expenditures should be supported by a detailed receipt or invoice, and an explanation as to the operational purpose of the expenditure, if unclear. Verification of proper supporting documentation for expenditures prior to payment could be integrated into the City’s corrective action plan for increased segregation of duties, as recommended in Finding 5.
 - Maintain financial and other related documentation in a logical manner that permits documents to be easily located for reference, monitoring, and audit purposes. Documentation should follow a record retention policy established by the City to ensure that documentation is maintained for a reasonable period of time. Implement the use of a voided check register, so that any voided checks can be accounted for and easily located.
 - Implement procedures to ensure all payroll disbursements, including payments to employees, withholding entities, and others, are properly supported and accurately calculated.
 - Develop documentation and approval requirements for petty cash. Documentation should not only include the total amounts withdrawn and deposited, but a running account of each transaction included in that total.
 - Close all unnecessary bank accounts to improve the oversight and monitoring of the accounts.
-

Finding 7: The City Used Public Funds For Inappropriate Expenditures

Auditors identified excessive and questionable uses of City funds during the expenditure testing discussed in Finding 6. As described throughout this report, the City does not have sufficient policies and procedures in place to properly manage the City’s resources, and segregation and monitoring of accounting functions are weak or non-existent. Such an environment can allow expenditures of public funds that do not have a legitimate operational purpose. Also, the examination identified that bonuses were paid to City employees, which is a prohibited practice for public employees.

Excessive and Questionable Expenditures

Auditors identified approximately \$4,441 in excessive and questionable expenditures during the examination. In the sample of expenditures tested, auditors noted purchases for gift cards and gift certificates. Based on inquiry, it was determined these gifts were given to employees as bonuses, which are discussed in further detail within this finding. Also, expenditures were found for flowers and gifts sent to City employees, elected officials, and their family members for bereavement and other occasions. Although these types of purchases are kind gestures, they are of a personal nature and are not reasonable and necessary expenditures to be paid from public funds. Also, auditors noted several charges to area restaurants for employees, officials, and, in five instances included family members of officials and employees. Upon inquiry, the majority of these meal-related expenditures were reported to be holiday meals for elected officials and their families, and therefore did not have a legitimate operational purpose.

Findings and Recommendations

The breakdown of excessive and questionable expenditures discussed above includes:

- \$2,241 in gift cards/certificates for City employees;
- \$725 in flowers and gifts sent to City employees, elected officials, and their family members for bereavement and other occasions; and
- \$1,475 in area restaurant charges without evidence of a legitimate operational purpose for the expenditures.

Reimbursement of Expenses

Additionally, concerns were noted during the examination related to expense reimbursements paid to employees and officials. Although the City generally lacked sufficient policies and procedures, there was a City policy in effect during the examination period regarding reimbursement for expenses. However, the reimbursement policy almost exclusively references travel outside the City and specifically states that “[r]eceipts for all expenditures are to be obtained and attached to the request for reimbursement, which must be completed as soon as possible upon completion of travel and submitted for payment not later than the last day of the month in which they were incurred.”

During the examination, auditors identified two checks issued in July 2015 totaling \$504 made payable to the City Clerk. The memo line on these checks indicated they were for meal allowances for periods as far back as 2008, but were not supported by receipts or other documentation to justify the reimbursement. Therefore, no details existed to help determine that the reimbursement was for legitimate expenditures. Although the Mayor signed both checks, auditors noted that the City Clerk herself was a second signor on one of the checks. The lack of supporting documentation makes it impossible to determine when the Mayor authorized the payments, and whether or not he had sufficient information to confirm that the City Clerk was in travel status and had incurred valid reimbursable expenses. This confirmation would be especially difficult without proper supporting documentation because the checks identified that the meal allowances were for years prior to the current Mayor being in office. Also, given that three to seven years had passed since the stated reimbursement period, even if valid, these payments did not follow the City’s reimbursement policy.

Another reimbursement related to a \$165 payment made to a City Council member based on an invoice that only contained the words “sod and labor.” It was impossible to determine from the documentation whether the City Council member was being reimbursed for a payment made on the City’s behalf or if the Council member actually performed the labor and provided the materials himself. Auditors inquired about this incident with the City Council member, who explained that he purchased sod to place on City property and hired a person to provide the labor. The supporting

Findings and Recommendations

documentation for the reimbursement was not an invoice from the vendor that performed the labor or provided the sod, but instead was an invoice from the City Council member with no detail to support that he had actually incurred this expense. The lack of detail on the invoice makes it difficult to determine whether a Form 1099-MISC should be issued since it appeared to be for contract labor. Finding 5 also discusses weaknesses identified in the City's Form 1099 reporting.

Employee Bonuses

Section 3 of the Kentucky Constitution prohibits the payment of bonuses to public employees for the performance of their duties. In spite of this prohibition, auditors identified an invoice identifying \$975 in gift cards were purchased for employees with public funds. The City Clerk indicated that in some years cash bonuses were paid, but prior City financial statement audits recommended that this practice be discontinued. The City did not stop the practice of giving employee bonuses, but instead changed its methodology to purchasing and distributing gift cards to employees.

Additionally, auditors identified a check in the amount of \$1,650 written during FY 2014 payable to "Christmas Bonus." There was no documentation to determine if this check was for one or more individuals, if the funds were used to purchase gift cards, or for some other purpose. Additionally, there was no evidence that bonuses paid were processed through payroll for proper wage and tax reporting.

Recommendations

As noted previously, the City should implement policies and procedures, including clear policies that address the type of expenditures that are allowable uses of public funds. The City should refrain from using public funds for employee bonuses in any form, purchasing flowers or gifts for bereavement and other occasions, meals for employees while not on travel status, and meals for family members of employees.

The City should also revise its reimbursement policy for clarification of permitted reimbursements, and ensure all employees receive a copy of the policy. The City should adhere to all policies enacted and should refrain from paying reimbursements that do not meet the City's requirements for proper supporting documentation and timeframe. Reimbursements for purchases made on behalf of the City should be very limited due to the unintended wage and tax consequences this practice can create, and thorough documentation should be maintained for any such reimbursements that cannot be avoided.

Finally, the City should establish strong review and approval procedures to detect noncompliant expenditures and to avoid unnecessary, excessive, and unauthorized expenses.

CITY OF IRVINE MAYOR'S RESPONSE

CITY OF IRVINE

101 Chestnut Street
Irvine, Ky. 40336
(606) 723-2554
Fax: (606) 723-2558

December 2nd, 2016

To: Mike Harmon
Auditor of Public Accounts
209 St. Clair Street
Frankfort, Ky. 40601

From: W.J. Noland, Mayor of Irvine
101 Chestnut Street
Irvine, Ky. 40336
mayornoland@irvineonline.net

RE: Preliminary Response to Management Performance Audit

Due to my short term as the Mayor of the City of Irvine, Kentucky, I was unaware of your findings. I am very concerned about these findings, and will make every possible effort to correct them. However, I will need some time to correct these problems. Many of these problems existed before I became the Mayor. I am now aware of your findings, and I will begin immediately to correct them. I will periodically inform you of my progress as I have completed each finding.

Respectfully,


W.J. Noland
Mayor of Irvine, Kentucky

IRVINE CITY COUNCIL RESPONSE



December 1, 2016

Mr. Mike Harmon
Auditor of Public Accounts
209 St. Clair Street
Frankfort, Kentucky 40601-1817

LAW OFFICES OF:

RODNEY GARRETT DAVIS*
JOAN DEATON GREFER
JENNIE Y. HAYMOND°
ADAM O. STANLEY

OF COUNSEL
S. MARK MATTHEWS*
SARA R. ELROD*

RE: *City of Irvine*
Draft Examination of Certain Policies,
Procedures, Controls and Financial Activity Report

230 N. SECOND STREET
P.O. BOX 1060
RICHMOND, KY 40476
859-624-3380
859-623-7333
859-624-0912 (FAX)

Dear Mr. Harmon:

133 MAIN STREET
P.O. BOX 150
IRVINE, KY 40336
606-726-9991
606-726-9772 (FAX)

I have been asked by the Irvine City Council to respond to your letter of November 29, 2016, and the attached Draft Examination of Certain Policies, Procedures, Controls and Financial Activity Report of the City of Irvine. It is my understanding that Mayor, W.J. Noland intends to complete his own written response to the draft report. In considering my responses please understand that City of Irvine appreciates each and every concern raised in your report and has already implemented, or will in the future implement, management controls to address your concerns. Additionally, the City Council wishes to clarify certain factual misconceptions that are contained in your report and set out facts that you may not otherwise be aware of.

181 MAIN STREET N.
MCKEE, KY 40447
(606) 287-4890
(606)287-4895 (FAX)

I must raise one limitation in my responses to any person reading this correspondence. It was not clear to the City Council members, or myself, what the reporting time frame was for your considerations. It appears that many of your concerns, especially those items related to financial management, were from prior periods and were identified, and at least partially corrected, following the presentation of the last several years of audit reports.

CBANK
8050 HOSBROOK ROAD
SUITE 111
CINCINNATI, OH 45236
513-351-1525
888-624-0912 (FAX)

I will address your findings sequentially for the ease of review:

WWW.DAVISLAWKY.COM
FED ID #61-1337953

Finding 1:

*LICENSED IN KY & OH
°LICENSED IN KY, OH & IN

Operating Environment:



There is no doubt that there have been disagreements between the Mayor and the City Council about certain basic governance issues related to the City of Irvine. These disagreements are typical in any governmental unit, are political in nature and do not lend themselves to resolution through implementation of any policy. However, that said none of these disagreements have resulted in the violation of any statutory duty by either the Mayor or the City Council. With all due respect to your findings, it is impossible to legislate a person's ability to effectively communicate with co-workers. However, the

Mr. Mike Harmon
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Council members are aware of this concern and are prepared to work with the Mayor to resolve these issues.

Poor Financial Management:

The City Council agrees with the finding that there is not sufficient staffing to allow for proper financial controls. This finding has been a part of every audit provided to the City of Irvine since I have been City Attorney, which has been approximately twelve years. Unfortunately, there are severe financial constraints that limit the City's ability to hire additional staffing. However, since the receipt of the last audit the Mayor and City Council have taken several steps to implement management controls to alleviate these issues. They have outsourced the City payroll, they have implemented a procedure whereby claims are reviewed and approved by the Mayor and City Council at each Council meeting to ensure accuracy, implemented a process whereby the current expenditures are compared to the budgeted amounts for each line item in the City's budget at each Council meeting and have contracted for a new software system regarding the collection and tracking of City tax bill collections. It is important to note that most of the weaknesses identified existed prior to the implementation of these new procedures.

Policies and Procedures:

The adoption of an administrative policy is the responsibility of the Mayor pursuant to KRS 83A.130(4) which states that the implementation of such procedures is subject to disapproval of the Council. The City of Irvine has in the past had an administrative code; however, the location of that code is not known at this time. The City Council agrees that such a procedural policy is necessary and encourages the Mayor to produce the policy for consideration and review, and stand ready to work with the Mayor to implement such a policy.

Lack of Review of Ordinances:

Your report indicates that the City of Irvine Code of Ordinances has not been reviewed as required by KRS 83A.060(11) and Section 32.40 of the Code of Ordinances. With all due respect, your finding is factually inaccurate. In 2011 the City of Irvine contracted with American Legal Publishing to recodify, index and republish the City of Irvine Code of Ordinances. At that time the City Clerk and I worked closely with American Legal Publishing to ensure a thorough review of the Code of Ordinances. I reviewed the Code and found no inconsistency with the Kentucky Revised Statutes at that time. Admittedly, it is time to undertake this review once more and with the direction of the Mayor and City Council this process can be initiated.

You cite a specific conflict with state law and the city ordinances as it relates to the removal of non-elected city officials. I will address this finding in response to your Finding 2.

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Finding 2:

**The City Has Not Followed State Law
In The Division Of Certain Responsibilities
Between The Mayor and City Council**

In this finding you have identified the following disagreements between the Mayor and City Council: 1) Removal of the City Clerk, 2) Removal of the Assistant City Clerk, 3) budget preparations, 4) hiring of the City Attorney and 5) selection of a CPA firm to complete the City audit. Again, I will address these sequentially:

1) Removal of City Clerk:

The City Council is not aware that Mayor has taken any action to remove the City Clerk. While there may have been discussions related to job performance the City Council is not aware that Mayor has ever attempted to discharge the City Clerk, nor has the City Council ever told the Mayor he did not have the power to discharge the City Clerk. During those discussions the City Council has discussed with the Mayor the difficulties that would be faced with discharging the City Clerk and has discussed ways to address her overwhelming job duties.

There is no doubt that the Mayor has authority to discharge the City Clerk pursuant to KRS 83A.080(3). There is also no doubt that a newly hired City Clerk must be approved by the City Legislative Body, i.e. the City Council, pursuant to KRS 83A.080(3). Hence, the Mayor and Council must work together to resolve this issue as the Mayor could theoretically discharge the City Clerk, yet have the Council decline to approve his choice for a new City Clerk. This would create considerable problems given that in the City of Irvine the City Clerk is the sole support staff that has hands on operation of City affairs on a daily basis.

In this section you find that Code of Ordinance Section 31.30 is in direct conflict with KRS 83A.080(3). Again, with all due respect this finding is inaccurate. Section 31.30 in no way conflicts with the Mayor's power to dismiss a non-elected city official at-will. This issue was squarely addressed by the U.S. Federal 6th Circuit Court of Appeals in Reeves v. City of Georgetown, Kentucky, 539 Fed.Appx. 662 (6th 2013). In Reeves the City of Georgetown had an ordinance almost verbatim to that of Section 31.30 and the Court specifically found that the city ordinance did not conflict with KRS 83A.080 or KRS 83A.130. Section 31.30 is a valid ordinance that only provides another avenue for removal of a non-elected city official. Accordingly, the Mayor has complete authority to dismiss the City Clerk; however, he would then have to manage the political and practical consequences of his actions.

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2) Removal of Assistant City Clerk:

The issue of the removal of the Assistant City Clerk requires a very fact specific inquiry. The Mayor hired an employee in a secretarial role which is not a position contained in the City's Code of Ordinance, hence it was an unlawful. I informed the Mayor and Council that the only role this employee could fulfill would be the roll of Assistant City Clerk. The Mayor asked, and City Council agreed, to hire the employee as an Assistant City Clerk. During the employee's probationary period issues arose regarding her willingness and ability to perform the job duties such as payroll and record keeping. The Council moved to terminate the Assistant City Clerk during her probationary as was permissible by Code of Ordinance Section 31.30 as the Assistant Clerk is a non-elected city officer. To date the Mayor has not moved to appoint another Assistant City Clerk. Section 31.30 is not in conflict with any state law as is more fully discussed in other sections of this response.

3) Budget Process and Responsibilities

There is no doubt that KRS 91A.030(5) provides the Mayor with sole authority to prepare and propose the City of Irvine budget. No City Council member has ever addressed the Mayor's power in this regard, or attempted to limit it in anyway. Once the budget is presented the Mayor and City Council have always worked together to reach a consensus on the proper budget. In fact, in all my years as City Attorney not once has the Council and Mayor been unable to pass a budget. This is true for current Mayor and is evidenced both by the minutes of the City Council meetings and by the fact that Mayor signed the budget ordinance every year. Had the Mayor disagreed with the budget he did not have to sign the budget ordinance. The fact that there were disagreements on the budget is not an indictment in anyway of the relationship between Mayor and Council, it is instead a policy reality that occurs in every political subdivision in the Commonwealth of Kentucky.

As you note, procedures have been implemented in response to previous audits regarding budget amendments occurring regularly and, as such, I will not directly address this concern.

4) Selecting City Attorney and CPA Firm:

There are three ways in which a City in Kentucky may retain a City Attorney (KLC-City Official Legal Handbook (2015)):

1. The legislative body may authorize and approve the hiring of a city attorney as an independent contractor by means of a personal service contract containing specific duties and compensation. The legislative body may also authorize the hiring of a city attorney as

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an independent contractor by simply including money in the budget for legal services. After the budget is adopted, the executive authority may retain an attorney, when necessary, with or without a written contract. This is the most common method by which city attorneys are hired.

2. The legislative body can create the position of city attorney as a full-time or part-time position of employment, with appointment by the mayor pursuant to KRS 83A.130(9), the city commission pursuant to KRS 83A.140(8), or the board of commissioners pursuant to KRS 83A.150(5).
3. The legislative body can create the nonelected office of city attorney requiring appointment by the executive authority of the city with approval of the legislative body, if separate from the executive authority. KRS 83A.080.

The City of Irvine has chosen the first option and the city attorney has always been a contract position that was approved in the budget process. This is the manner in which I was hired many years ago and it remains the scope of my services to the City. Again, I am not a non-elected officer of the City of Irvine. The Mayor has in the past questioned whether or not I have a conflict given that I am the elected Estill County Attorney. Again, this issue has been squarely resolved by the Kentucky Attorney General many years ago when Opinions Attorney General (AOG) 81-403 and 83-495 were issued. AOG 83-495 makes it clear that a conflict only exists between being city attorney and county attorney if the city attorney is a non-elected officer of the city.

To my knowledge the Mayor no longer questions my ability to serve as City Attorney and this is evidenced by the City Council meeting in October, 2015, when he again confirmed his position that he was content with me being the City Attorney. Admittedly, it is appropriate to execute a new contract and I will tender one to the Mayor and City Council for consideration.

When the issue arose regarding retention of a CPA firm to catch-up several years of City audits the Mayor proposed White & Associates to complete the audits. The City Council did not object and the audits were completed. When last year's audit came up several Council member expressed reservations regarding retention of White & Associates and in an open City Council meeting the Council and Mayor agreed to seek other options and tasked the City Clerk with obtaining bids. Several bids were produced and everyone agreed to hire RFH, LLC. The Mayor agreed with this course of action as is well evidenced by his signature on the engagement letter with RFH, LLC dated February 23, 2016.

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No Council member disputes that the Mayor is the executive authority in the City of Irvine and is the only person that execute a contract; however, he cannot execute a contract for professional services that is not otherwise funded in the budget. This creates the necessity, as in all Cities, to reach a political compromise on the appropriate course of action. By your rationale the Mayor would have unfettered ability to execute contracts on behalf of the City without regard to the budgetary process. I do not believe this is the state of the law in the Commonwealth of Kentucky.

Finding 3:

**The City Routinely Failed to Meet Statutory
Financial Reporting Requirements, Resulting in
Noncompliances and State Funding Being Withheld:**

This finding appears to relate to prior periods and is a direct result of the City's contracted vendor failing to timely complete City audits. The prior auditing firm failed to timely complete the audits which led to the City's inability to timely file certain financial statements. The Mayor and Council addressed this issue by retaining a new audit firm and by putting in place financial controls such as reviewing claims at each council meeting and by reviewing comparative budget numbers at each council meeting.

**City Audits and Uniform
Financial Information Reports:**

The issues raised in this section of the report appear to arise from previous periods. As noted above, these deficiencies have been addressed by working with firms conducting the City's audit and by a firmer review of the financials at each City Council meeting. Again, many of the reporting issues relate to reliance on outside vendors for information that was not timely.

Finding 4:

**Errors In Payroll And Contract Labor Tracking
Led To IRS Penalties, State Revenue Intercepts, And
A Failure to Issue 1099s To Contractors:**

These issues appear to arise in prior periods and based on the audit reports and recommendations the Mayor and City Council have elected to outsource payroll which should address the majority of these issues.

Management will address the weakness in the incomplete personnel files.

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Management is aware of the lack of proper 1099 reporting but based on the recent audits has addressed that issue.

The recommendation that by outsourcing payroll it would create potential to eliminate the full time position of the City Clerk is not realistic. The payroll is only a minor function and even removing that responsibility does not create the need for less employees. In fact, it is likely that a proper Assistance City Clerk is needed given the City Clerk's extensive duties that entail far more than her financial and accounting duties.

The City's Accounting Functions Are Not Segregated, Increasing Opportunities For Waste, Fraud, And Abuse To Occur And Not Be Detected:

Segregation of duties is impossible when the department only has one employee; however, the Mayor and City Council have implemented procedures to ensure financial clarity by reviewing all claims and the budget progress at each City Council meeting.

Finding 6:

The City Has Weak Internal Controls Over Disbursements From The City's Bank Accounts:

As stated above the Mayor and Council have undertaken regular review of claims and disbursements at each Council meeting. The errors identified are known and should be resolved with the new procedures.

The City Council recommends that a petty cash journal be presented at each City Council meeting for the interim period prior to the City Council meeting.

Finding 7:

The City Used Public Funds For Inappropriate Expenditures:

Management is now aware of these issues as identified by the previous audits and expenditures of this nature have been terminated.


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I apologize for the length of my response and I ask that you do not consider the lengthy response as questioning the credibility of your report. However, the City Council did believe it was important that you were aware of all the facts and possessed a full understanding of why certain issues occurred. The City Council takes your report and recommendations very seriously and will work hard to ensure that the City of Irvine is compliant with all applicable statutory obligations and to ensure the citizens of the City of Irvine have an efficient city government.

Thank you for your attention to this correspondence. If you have any questions please do not hesitate to contact our office.

Sincerely,

DAVIS LAW, P.S.C.



Rodney G. Davis
rgd@davislawky.com

AUDITOR'S REPLY TO IRVINE CITY COUNCIL'S RESPONSE

Auditor's Reply to Irvine City Council's Response

While we appreciate the response provided by the Irvine City Council, certain comments in the response warrant correction or clarification. The City Attorney, in responding on behalf of the Irvine City Council, indicated there was confusion regarding the timeframe of the examination. The examination time period was communicated in the examination engagement letter provided to the Mayor and Mayor Pro Tem at the beginning of the examination. However, we recognize that in the examination itself, the timeframe is presented in the background section that was not provided as part of the draft report findings for response. The engagement letter and background section of the examination identify the timeframe covered as July 1, 2013 through March 31, 2016, unless otherwise stated in individual responses. The City Council's response indicates many of the concerns presented in the examination findings, especially related to financial management, were previously identified and at least partially addressed. However, except where noted, auditors were unable to determine that effective corrective action had taken place on the issues included in the report.

The absence of sufficient corrective action is also indicated in the City's recent FY 2015 financial statement audit dated September 22, 2016, which contained a serious finding that stated: "The City lacks personnel with the expertise to apply generally accepted accounting principles in preparing its financial statements including note disclosures, and thus, does not have the internal control procedures required to take responsibility for the financial statements in conformity with generally accepted accounting principles." Management's response in the FY 2015 audit acknowledges this is an ongoing finding. It is important for the Irvine City Council to recognize that the lack of expertise mentioned in the finding may extend to other functions, and that serious weaknesses continue to exist within the City's financial management that need to be addressed. We believe our report provides sound recommendations that can act as a starting point in this effort.

Also, the APA acknowledges that limited staffing can exacerbate financial management weaknesses, but the City Council's response does not address the examination concerns as to whether problems were a result of inadequate training and skills, or even neglect of duty. The examination identified very serious weaknesses in internal controls and financial operations, which increase the chance the City could lose funds through waste, fraud, or abuse. Although the examination credits the City with attempts to address some concerns, such as outsourcing the payroll function, the actions noted during the examination and those included in the City Council's response are not sufficient to address some of the most serious concerns identified.

On the finding related to the City's review of ordinances, we would like to reiterate that this comment resulted from interviews directly with City Council members. As indicated in Finding 1, several City Council members interviewed agreed that the City's Code of Ordinances had not been reviewed in the past five years to ensure consistency with state law, for any conflicts between ordinances, or to eliminate redundant, obsolete, inconsistent, and invalid provisions.

In its response to the finding related to the removal of nonelected City officers, the City Council argues that the finding is inaccurate and that the City's Code of Ordinance Section 31.30 is not in conflict with KRS 83A.080(3), citing the case Reeves v. City of Georgetown, Kentucky, 539 Fed.

App'x 662 (6th Cir. 2013). In our view, the Reeves case is distinguishable from the circumstances of the City of Irvine, as the City of Georgetown's ordinance only permitted the city council to remove an employee "for cause" rather than the "at will" language contained in the City of Irvine's ordinance. The Irvine ordinance seems intended to supplant the Mayor's authority rather than to provide an additional means to dismiss an employee. Further, interviews indicated that it has been interpreted in this way by members of the City Council. The APA stands by its conclusion that the current City ordinance conflicts with the Mayor's statutory authority for the removal of non-elected officials.

As it relates to the hiring of the City Attorney, the response mischaracterizes the APA's finding. The examination states, "The Mayor has the authority to enter into professional services contracts on behalf of the City so long as the contracts are in accordance with budgeted amounts for such services." The report does not dispute the City Council's ability to hire "a city attorney as an independent contractor by means of a personal service contract containing specific duties and compensation." The report merely identifies the lack of a known contract with the City Attorney, the absence of which indicates the City Attorney was procured through the budgetary approval method. Under this method, the Mayor would have authority to retain an attorney when needed with or without a written contract. The APA does recommend the use of written contracts for professional services.

Additionally, as it relates to the hiring of the City's CPA firm to conduct its FY 2015 audit, the City Council's response indicates several bids were produced. Inquiry with the City Clerk did not identify the existence of any bids. Also, as a point of clarification, the examination identified the Mayor as the executive authority responsible for procuring the CPA firm for audit, which is not the same as accepting the approved firm.

Again, throughout its remaining response, the City Attorney indicates that issues raised in the examination were related to previous periods, insinuating that the issues have been resolved and were no longer current. Throughout the examination, the APA provides the City Council ample evidence of serious and repeated findings, and has communicated that these matters are of such concern that they will be referred to other state and federal agencies for potential further investigation. We would like to reiterate that it is imperative for the City Council to work to investigate and resolve these matters in order to properly protect the taxpayers of the City of Irvine.